IN THE
SUPREME COURT OF MISSOURI

No. SC83859

SOUTHWESTERN BELL TELEPHONE COMPANY,

Appellant,

v.

DIRECTOR OF REVENUE,

Respondent.

Petition For Review
From The Administrative Hearing Commission,
The Honorable Willard C. Reine, Commissioner

Respondent's Brief

JEREMIAH W. (JAY) NIXON
Attorney General

ALANA M. BARRAGÁN-SCOTT
Missouri Bar No. 38104
Deputy State Solicitor

Post Office Box 899
Jefferson City, Missouri 65102
Phone: (573) 751-3321
Facsimile: (573) 751-9456

ATTORNEYS FOR RESPONDENT
DIRECTOR OF REVENUE

Table of Contents

Table of Contents 2

Table of Authorities 4

Jurisdictional Statement 7

Statement of Facts 8

Point Relied On 14

Standard of Review 15

Argument 16

I. The exemptions 17

II. As a threshhold matter, Bell did not "manufacture" anything within the meaning of the second prong of the exemptions 19

III. Bell did not establish that the items were "used directly," within the meaning of the second prong of the exemptions 33

IV. Bell did not establish that all of the items were machinery and equipment, or materials and supplies solely required for the installation or construction of such machinery and equipment . . . 38

V. Bell did not demonstrate that the items were used in or even near the 2nd quarter of 1992 40

VI. If the Court disagrees with the Commission, and finds that Bell is entitled to the exemptions, the decision will have been unexpected and the Court should apply it prospectively 41

Conclusion 44

Certification of Service and of Compliance with Rule 84.06(b) and (c) 45

Appendix A-1

Table of Authorities

Cases:

Bridge Data Co. v. Director of Revenue, 794 S.W.2d 204 (Mo. banc 1990) 24, 25, 27, 28, 32, 42

Concord Publishing House, Inc. v. Director of Revenue, 916 S.W.2d 186 (Mo banc 1996) 26, 37, 40, 41

DST Systems, Inc. v. Director of Revenue, 43 S.W.3d 799 (Mo. banc 2001) . . 37

Floyd Charcoal Co. v. Director of Revenue, 599 S.W.2d 173 (Mo. banc 1980) 36

Galamet, Inc. v. Director of Revenue, 915 S.W.2d 331 (Mo. banc 1996) 26

GTE Automatic Electric v. Director of Revenue, 780 S.W.2d 49 (Mo. banc 1989) 24-25, 27, 28, 32, 42, 43

Heidelberg Central, Inc. v. Director of Revenue, 531 S.W.2d 752 (Mo. 1972) 20-22, 30

Hogan Transports, Inc. v. Director of Revenue, No. 98-1305RV (Mo. AHC 1999) 41

House of Lloyd v. Director of Revenue, 824 S.W.2d 914 (Mo. banc 1992) . . . 31

International Business Machines Corp. v. Director of Revenue, 958 S.W.2d 554

(Mo. banc 1997) 19, 24, 26, 32, 43
J.B. Vending Co., Inc. v. Director of Revenue, 54 S.W.3d 183 (Mo. banc 2001) 38
Jackson Excavating v. Administrative Hearing Commission, 646 S.W.2d 48 (Mo. 1983) 21, 26, 27
L&R Egg Co. v. Director of Revenue, 796 S.W.2d 624 (Mo. banc 1990) . . 19, 20, ... 26
Lincoln Industrial, Inc. v. Director of Revenue, 51 S.W.3d 462 (Mo. banc 2001) 28, 32, 38
Mid-America Dairymen v. Director of Revenue, 924 S.W.2d 280 (Mo. banc 1996) 26
State ex rel. AMF Inc. v. Spradling, 518 S.W.2d 58 (Mo. 1974) 21
Unitog Rental Services v. Director of Revenue, 779 S.W.2d 568 (Mo. banc 1989) 22
Walsworth Publishing Co. v. Director of Revenue, 935 S.W.2d 39 (Mo. banc 1996) 39
West Lake Quarry & Material Co. v. Schaffner, 451 S.W.2d 140 (Mo. 1970) 20-22, 30
Wilson & Co., Inc. v. Director of Revenue, 531 S.W.2d 752 (Mo. 1976) 21

Statutes:

§143.903.1, RSMo 2000 42

§143.903.2, RSMo 2000 42

§144.010.1(8)(c), RSMo Supp. 1992 16

§144.020.1(4), RSMo Supp. 1992 . . . . . 16, 28, 29

§144.030.2(4), RSMo Supp. 1992 . . . . . 17, 18, 39

§144.030.2(5), RSMo Supp. 1992 17-19

Jurisdictional Statement

This is an appeal from a decision by the Administrative Hearing Commission, upholding the Director of Revenue's denial of a refund of use tax on Southwestern Bell's purchase of various items. This Court has exclusive jurisdiction over this matter, as it involves the construction of the revenue laws of this state. Mo. Const. Art. V, § 3.

Statement of Facts

The Director agrees with and adopts some portions of the Statement of Facts contained in Appellant Bell's opening brief, specifically, the facts set forth in Sections B, C and D, on pages 8-23 (the descriptions of telephone technology, telephone network equipment, and basic local telephone service, respectively).

The Director adds the following here for purposes of clarity:

Vertical services. During the relevant tax period, 2nd quarter 1992, Bell provided both basic and what it called vertical services; Bell also implemented and offered other vertical services after the tax period. Bell sought the manufacturing exemptions for items that it purchased during 2nd quarter 1992, to which it attributed the alleged manufacture of basic telephone services, and vertical services implemented and offered both during and after the tax period. A description of the services, with their dates of implementation, in parentheses, follow. Dates of implementation are drawn from Exhibit 31.

Auto redial (7/2/89). A feature that allows a customer to hang up the phone when receiving a busy signal and have the telephone system monitor the number. When the called number becomes idle, the telephone system rings the called number and the calling number without the need to redial the called number. LF 25 (Finding of Fact 62). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Call blocker (7/2/89). The customer creates a list of numbers from which the customer does not wish to receive calls. The customer receives a block of memory in the switching machine in which to input those numbers. Call from those numbers are routed to an announcement stating that the customer is not accepting calls from that number. The customer's number does not ring. LF 25-26 (Finding of Fact 63). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Call forwarding (12/22/72). A feature that allows the customer to have calls directed to the customer's phone number automatically rerouted to another number, based on instructions that the customer has put into the telephone. LF 26 (Finding of Fact 64). The service is produced from the originating switch and does not require the SS7 system. LF 27 (Finding of Fact 74).

Selective call forwarding (7/20/89). A variation of call forwarding that allows only certain numbers to be forwarded. LF 26 (Finding of Fact 65). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Call return (7/2/89). Allows the customer to dial a code, and the system will retrieve the number that last called the customer, and place a call to that number. LF 26 (Finding of Fact 66). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Call trace (7/2/89). Allows the customer to activate a code so the number that calls the customer is recorded and printed out on a printer. Call trace is designed for customers who receive threatening or harassing calls. LF 26 (Finding of Fact 67). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Call waiting (12/22/72). Allows the customer to be alerted by an audible tone of an incoming call when the customer is on another call. The customer has the option of placing the original call on hold by pressing the switch hook; the customer can go back and forth between the two calls. LF 26 (Finding of Fact 68). The service is produced from the originating switch and does not require the SS7 system. LF 27 (Finding of Fact 74).

Priority call (7/2/89). Allows the customer to assign a distinctive ringing signal to certain incoming calls. The customer is assigned memory in the switching machine into which the customer may input numbers for which the customer designates distinctive rings. LF 26 (Finding of Fact 69). This service requires the SS7 system. LF 27 (Finding of Fact 72).

Speed calling (12/22/72). Allows the customer to store up to 32 phone numbers in the memory of the central office switch and call them by using a one- or two-digit code. LF 27 (Finding of Fact 70). The service is produced from the originating switch and does not require the SS7 system. LF 27 (Finding of Fact 74).

Three-way calling (12/22/72). Allows a customer to create a conference call by dialing phone numbers and using the switch hook. LF 27 (Finding of Fact 71). The service is produced from the originating switch and does not require the SS7 system. LF 27 (Finding of Fact 74).

Bill plus (9/4/92). Bell's equipment collects data from Bell's billing systems and puts it on a floppy disk, that is provided to the customer on a monthly basis. The customer may also purchase software that can read the disk and organize it into reports and graphs. LF 28 (Finding of Fact 77). This service uses the accounting computers and the switching equipment. LF 28 (Finding of Fact 79). *Customer billing report, or CBR* (6/18/90). A service similar to bill plus. Bell prints out the report pursuant to the customer's specifications. LF 28 (Finding of Fact 78). This service also uses the accounting computers and the switching equipment. LF 28 (Finding of Fact 79).

Local measured service (6/2/80). This service allows the customer unlimited incoming calls, but a limited number of outgoing calls at a flat monthly rate. Outgoing calls in excess of the minimum carry a charge; detailed billing is available. LF 28 (Finding of Fact 80).

CABS billing on floppy disk (trial began June 1994, implemented July 1994). Used to bill interchange carriers. The mechanism for collecting the data which is in the central office switch was put in place in 1984. Tr. 455.

The Commission's decision. The Commission held a three-day hearing, generating a 684-page transcript, and admitting almost 40 exhibits. Its decision contains 107 Findings of Fact, in addition to the legal analysis.

The Commission held that Bell is not entitled to either exemption for the primary reason that Bell was not engaged in manufacturing, whether as a matter of legal interpretation or on the record that Bell presented. The Commission found that in spite of the voluminous record, "the evidence is not very explicit as to how various system components transform information into the assorted vertical services." LF 44. Further, whether Bell provides vertical services does not transform the system into a manufacturing concern. LF 43.

The Commission further held that Bell could not gain the benefit of exemptions for services implemented subsequent to the tax period. LF 45.

The Commission also found that Bell had not established how various items such as labels, could qualify as machinery and equipment, or materials and supplies solely used to install such machinery and equipment. And some items were likely completely disqualified for the exemptions. LF 47.

The legislature did not intend for all telephone system components to be held exempt as "directly used" in manufacturing a product. Therefore, the Commission rejected Bell's integrated plant argument. LF 48-49.

Point Relied On

The Commission did not err in denying Southwestern Bell a use tax refund for second quarter 1992 for the exemption for replacement machinery and equipment for manufacturing, or the exemption for expansion of existing manufacturing, because the decision is supported by competent and substantial evidence on the whole record, and a correct application of the law, in that Bell did not establish that it was engaged in manufacturing; Bell did not establish the other elements of the exemptions; and Bell did not offer the services that it claimed to manufacture in second quarter 1992. In the alternative, if the Court finds Bell qualifies for either exemption, then the decision will be unexpected, and the Court should apply it prospectively.

GTE Automatic Electric v. Director of Revenue, 780 S.W.2d 49 (Mo. banc 1989)

Bridge Data Co. v. Director of Revenue, 794 S.W.2d 204 (Mo. banc 1990)

International Business Machines Corp. v. Director of Revenue, 958 S.W.2d 554 (Mo. banc 1997)

§144.030.2(4), RSMo Supp. 1992

§144.030.2(5), RSMo Supp. 1992

Standard of Review

Because this is a tax exemption case, Southwestern Bell bore the burden of proof at the Commission. §§136.300, RSMo 2000, and 621.050.2, RSMo 2000. This is a burden to produce clear and unequivocal evidence. *Concord Publishing House v. Director of Revenue*, 916 S.W.2d 186, 195 (Mo. banc 1996) (citation omitted). And tax exemptions are strictly construed against the taxpayer. *Branson Scenic Railway v. Director of Revenue*, 3 S.W.3d 788, 790 (Mo. App. W.D. 1999).

Review of the Commission's decision is limited to the determination of whether that decision was supported by competent and substantial evidence on the whole record, or whether it was arbitrary, capricious, unreasonable, unlawful, or in excess of its jurisdiction. *J.B. Vending Co., Inc. v. Director of Revenue*, 54 S.W.3d 183 (Mo. banc 2001) (internal quotations marks and citation omitted).

Argument

The Commission did not err in denying Southwestern Bell a use tax refund for second quarter 1992 for the exemption for replacement machinery and equipment for manufacturing, or the exemption for expansion of existing manufacturing, because the decision is supported by competent and substantial evidence on the whole record, and a correct application of the law, in that Bell did not establish that it was engaged in manufacturing; Bell did not establish the other elements of the exemptions; and Bell did not offer the services that it claimed to manufacture in second quarter 1992. In the alternative, if the Court finds Bell qualifies for either exemption, then the decision will be unexpected, and the Court should apply it prospectively.

The threshold issue before the Commission was whether Southwestern Bell, in its provision of telephone service and services pertaining or incidental thereto,[1] was

---

[1] The sale of telephone service, and services pertaining or incidental thereto, was explicitly covered during the relevant time as a taxable service at retail by §144.020.1(4), RSMo Supp. 1992. Appendix, A-1. In defining "sale at retail," the legislature addressed the sale of telephone service at §144.010.1(8)(c), RSMo Supp. 1992. Appendix, A-2.

engaged in manufacturing. The Commission held that Bell is not manufacturing – a decision that is correct legally, factually and logically. The Commisison also correctly determined that Bell did not otherwise establish certain elements of the exemptions.

I. The exemptions

The two exemptions of which Bell sought to take advantage for the second quarter of 1992 cover replacement machinery and equipment, and plant expansion. Section 144.030.2(4), RSMo Supp. 1992, provided an exemption from tax on the purchases of:

> Machinery and equipment and the materials and supplies solely required for the installation or construction of such machinery and equipment, replacing and used for the same purposes as the machinery and equipment replaced by reason of design or product changes, which is purchased and used directly in *manufacturing* or fabricating a product which is intended to be sold ultimately for final use or consumption[.][emphasis added]

Section 144.030.2(5), RSMo Supp. 1992, provided an exemption from tax on the purchases of:

> Machinery and equipment, and the material and supplies solely required for the installment or construction of such machinery or equipment, purchased and used to establish new or expand existing *manufacturing*, mining, or fabricating plants in this state if such machinery and equipment is used directly in *manufacturing*, mining or fabricating a product which is intended to be sold ultimately for final use or consumption[.][emphasis added][2]

As the Commission noted, the common elements of both exemptions contained in §144.030.2(4) and §144.030.2(5), are: 1) machinery and equipment, or materials and supplies solely required for the installation or construction of such machinery and equipment; 2) used directly in manufacturing or fabricating a product; and 3) the product must be intended to be sold ultimately for final use or consumption. The Director disputed the common elements below.

Both sections require additional, different elements; the Director did not dispute below whether Bell had established these separate elements. Section 144.030.2(4)

[2]In addition to "manufacturing," both statutes encompass the processes of "fabricating"; the latter also includes "mining." Bell has never argued that its provision of telecommunications services is fabricating (or mining).

requires as two additional elements: 4) the machinery and equipment to replace and be used for the same purpose as the machinery and equipment replaced; and 5) that the replacement be due to design or product change. And §144.030.2(5) requires, as one additional element: 4) that the machinery and equipment be used to establish new or expand existing manufacturing, mining or fabricating plants. LF 36.

II. As a threshhold matter, Bell did not "manufacture" anything within the meaning of the second prong of the exemptions.

The principle flaw in Bell's argument is that it ignores the cardinal rule of statutory interpretation: that the Court must first give effect to the plain language of these statutes. *International Business Machines Corp. v. Director of Revenue,* 958 S.W.2d 554, 557 (Mo. banc 1997), *citing L&R Egg Co. v. Director of Revenue,* 796 S.W.2d 624, 625 (Mo. banc 1990). Bell would add language to the statutes that is not there, or change the language that is.

In drafting the instant statutes, the legislature did not -- though it could have -- word them so broadly as to exempt everything that is used in producing a product that a business will sell at retail. Rather, the legislature contoured the exemptions in several ways, including requiring that the items be "used directly" in "manufacturing" products. Had the legislature intended for the exemptions to have been more broad, the legislature

would not have limited the exemptions in the manner it did, including limiting the processes to which it applied the exemptions -- manufacturing, fabricating and mining.

Decisions prior to *GTE*. This Court has on several occasions in at least the last three decades examined the definition of manufacturing, as used in these and like exemptions, shunning the expansive interpretation argument that Bell presses. The essential thread in this Court's exemption jurisprudence is that manufacturing involves a change, that is, a change in the thing that goes in at the beginning of the process, relative to what comes out at the end of the process, and that the change is more than incidental. *See L&R Egg Co., Inc. v. Director of Revenue,* 796 S.W.2d 624, 627 (Mo. banc 1990)("While manufacturing implies a change, not every change is manufacturing.").

In 1970, this Court defined manufacturing as

> tak[ing] something practically unsuitable for any common use and chang[ing] it so as to adopt it to such common use.

West Lake Quarry & Material Co. v. Schaffner, 451 S.W.2d 140, 143 (Mo. 1970). Accordingly, it was manufacturing to crush rock and make the rock suitable for use in road beds. *Id*.

Two years later, in *Heidelberg Central, Inc. v. Director of Revenue,* 531 S.W.2d 752, 754 (Mo. 1972), the Court held that producing "new and different articles from

raw materials by the use of machinery, labor and skill, ... in forms suitable for new uses" is manufacturing. Therefore, producing custom business forms, stationery, printed ads, postcards, and church bulletins was manufacturing. *Id.*

Two years after *Heidelberg*, the Court in *State ex rel. AMF Inc. v. Spradling*, 518 S.W.2d 58 (Mo. 1974), reiterated the importance of the centrality of the change in use, when it held that repairing and retreading worn tire carcasses is not manufacturing; the process simply restores a tire to its originally intended use.

And two years later, the Court in *Wilson & Co., Inc. v. Director of Revenue*, 531 S.W.2d 752, 754-755 (Mo. 1976), held that the definitions of manufacturing from *West Lake* and *Heidelberg* compelled its conclusion that the conversion of live hogs into marketable portions of food suitable for human consumption and other marketable products is manufacturing.

After a short break in manufacturing cases, the Court in *Jackson Excavating v. Administrative Hearing Commission*, 646 S.W.2d 48, 51 (Mo. 1983), again explained that manufacturing is

> transformation of a raw material by the use of machinery, labor and skill into a product for sale which has an intrinsic and merchantable value in a form suitable for new uses.

Therefore, processing undrinkable water is into drinkable water is manufacturing. *Id*.

But cleaning uniforms for reuse is not. *Unitog Rental Services v. Director of Revenue*, 779 S.W.2d 568, 570 (Mo. banc 1989). The processing found to constitute manufacturing in the Court's cases prior to *Unitog* "produced a new and different product, dissimilar to any previous condition of the processed article." *Id.* No such change occurred with respect to the cleaned uniforms. *Id.*

***GTE* and susbsequent cases.** In view of the then-almost two decades old line of manufacturing cases, and because the "Court's construction of statutory language becomes a part of the statute that must be read as incorporating the judicial interpretation placed upon it[,]" *Unitog*, 779 S.W.2d at 571 (citation omitted), it is not surprising to find in the majority opinion in *GTE Automatic Electric v. Director of Revenue* -- a case in which a phone company sought a manufacturing exemption -- the observation that "[t]elecommunications clearly does not fit into the [*Heidelberg*] definition of manufacturing[,]" and the remark, "We do not believe that the [*West Lake*] definition of manufacturing applies to telecommunications." 780 S.W.2d 49, 51 and 52 (Mo. banc 1989).[3]

---

[3]The majority in *GTE* explained that *Heidelberg* required the end result of manufacturing to have an intrinsic value. But the end result of the process at issue in *GTE* was a telephone signal -- and that signal had no intrinsic value. 780 S.W.2d at

GTE is admittedly of limited value in some respects, because the majority did not squarely address Appellant GTE's central argument, which was whether it engaged in manufacturing. The Court focused on a separate, and ultimately dispositive, issue: "While this point [whether GTE is manufacturing] certainly bears on the issue at hand, we feel the more pertinent inquiry is whether the output of the equipment is a product or service." 780 S.W.2d at 50. The majority proceeded to decide that because GTE produced a service, it could not gain the benefit of an exemption that used the word "product"; in other words, a "service" could not be a "product." Therefore, the Court held, GTE was not entitled to the exemption.

---

51. The majority further explained that *West Lake* described "manufacturing as involving raw elements that are unsuitable for common use. It is futile to argue that the human voice is unsuitable for common use when that very thing is commonly used every day." 780 S.W.2d at 52.

Further, it is interesting to note that the Commission's underlying decision in *GTE*, AHC no. RS-86-0730, involved some of the same or similar services as those that are at issue in the instant case, such as transmission of voice messages, call transfers, special billing and malicious call hold. *See* Finding of Fact no. 13, therein.

Bell correctly points out that the dissent in *GTE* is sharply worded, and that it took to task the majority's assumption that a product must be tangible personal property. 780 S.W.2d at 53-54. The dissent also explained that, in contrast to the majority, it would have decided that the production of telephone signals was manufacturing, based on *Jackson Excavating*. *Id.* at 54 ("[T]he device producing the digital signal causes 'a substantial transformation in quality and adaptability and creates an end product quite different from the original.'").

As the Commission pointed out below, LF 38 n. 7, the Court subsequently trimmed its holding in *GTE* when it decided *International Business Machines Corp. v. Director of Revenue*, 958 S.W.2d 554 (Mo. banc 1997). In *IBM*, the Court held that *GTE* should no longer be followed to the extent that it suggests a product must be tangible. *Id.* at 557.

But Bell is simply wrong when it argues that this Court's precedents compel the conclusion that producing telephone service, including services, is manufacturing. Appellant's Brief, p. 42 n.4. The Court's precedents in fact compel the contrary conclusion -- the conclusion that the Commission drew here. A unanimous Court in *Bridge Data Co. v. Director of Revenue*, held that a manufacturing exemption should be allowed when a taxpayer collects, organizes, and supplies sophisticated financial

data to its customers. 794 S.W.2d 204 (Mo. banc 1990). Without citing the source of its definition of manufacturing, the Court simply explained that

> what comes out of the system is clearly different from what went into it, *in contrast to GTE, in which the telephone company purported to transmit, as accurately as possible, the voices of the participants,* even though what one learned in theoretical physics might demonstrate that what came out was not really the same as what went in. [emphasis added]

794 S.W.2d at 206 (citing to *GTE*, dissenting opinion of Robertson, J., 780 S.W.2d 53).[4] *Bridge Data* stands for the proposition that producing teleophone service is not manufacturing.

The same is true with respect to decisions subsequent to *Bridge Data* concerning manufacturing exemptions. For example, twice in 1996, the Court held that

> manufacturing consists of the alteration or physical change of an object or material in such a way that produces an

[4]It is interesting to note that the author of the dissent in *GTE,* and the two members of the Court who joined him there, were also members of the Court at the time that it issued its unanimous opinion in *Bridge Data*.

> article with a use, identity, and value different from the use, identity, and value of the original.

Galamet, Inc. v. Director of Revenue, 915 S.W.2d 331, 333 (Mo. banc 1996). *And see Mid-America Dairymen v. Director of Revenue*, 924 S.W.2d 280, 283 (Mo. banc 1996)(same). *See also L&R Egg Co. Inc. v. Director of Revenue*, 796 S.W.2d 624, 622-627 (Mo. banc 1996)(equipment used to clean and pack eggs is not manufacturing equipment; fundamental use of eggs is same at end of process).

In *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186, 191 (Mo. banc 1996), the Court established that organizing information through computer technology is manufacturing, where computer and computer equipment were used to implement changes in the newspaper production process and newspaper format. The Court then applied *Concord* in *International Business Machines, Corp. v. Director of Revenue*, 958 S.W.2d 554 (Mo. banc 1997). In *IBM*, an entity collected financial data and performed transactions with it, including buying and selling mutual fund shares, purchasing securities from the funds, valuing fund portfolios, pricing the funds, and updating shareholder records on a daily basis. *Id* at 556. The manipulation of the data to create new forms of output, including various reports and statements, dividend and redemption checks, tax information forms, and net asset values. *Id*. Citing *Concord*, the Court in one paragraph concluded that that was manufacturing.

Id. at 558. The Court then went on to discuss whether a product must be tangible to qualify for the manufacturing exemption, and ultimately concluded that it did not. *Id.* at 557-560.

Though the Court did not engage in a detailed analysis of the manufacturing question in *IBM*, the process appears to fall within the Court's prior definitions of manufacturing. The manipulation of financial data, to create new forms of output, including different types of reports and statements, dividend and redemption checks, tax information forms, and net asset values is a process that takes raw financial data and turns it into something new, something suitable for new uses. *E.g. Jackson Excavating*, 646 S.W.2d at 51 (transforming raw material by use of labor and skill into product for sale that has intrinsic and merchantable value, in form suitable for new uses, is manufacturing).

Bell falls under no established definition of manufacturing. This Court's now almost three decades worth of examination of the definition of manufacturing for purposes of tax exemptions has been somewhat fact intensive, but consistent in the main. The word "manufacturing," in the plain and ordinary sense, and as construed by this Court, involves -- and has always involved -- a fundamental change in a product, altering or changing an object or material into a form suitable for new use.

Further, a majority of the Court in *GTE* and later a unanimous Court in *Bridge Data* suggested fairly strongly that the provision of telephone service is not manufacturing. Since *GTE* and *Bridge Data*, the legislature has tinkered with the statutes concerning taxation of telephone service, but has not undone those decisions.[5] Bell's arguments do not compel a decision that would upset the reasonable expectation of the public and the legislature that -- based on *GTE* and *Bridge Data*, and taking the words of the statute in their plain and ordinary sense -- telephone service, including services pertaining or incidental thereto, is not "manufactured." *See Lincoln Industrial, Inc. v. Director of Revenue*, 51 S.W.3d 462, 465 (Mo. banc 2001)(Per §1.090, RSMo., "[c]ourts are instructed by the legislature to take the words in a statute in their plain and ordinary sense.").

Further, evidence that Bell adduced before the Commission establishes that its customers are putting in at one end of the phone line the same thing that comes out at the other end -- an analog signal. A telephone contains a microphone or carbon element. The sound of the customer's voice excites the carbon particles within the mouthpiece, causing them to vibrate and produce an analog reproduction of the

[5]For example, §144.020.1(4), RSMo 2000, now speaks in terms of taxing "telecommunications service." The corresponding definition of that phrase is found in §144.010.1(13), RSMo 2000.

customer's voice. The analog signal is carried from the customer's location over telephone wires, by electrical current, to Bell's central office facility. LF 22 (Finding of Fact 47) and Exhibit A. That current may take many turns through Bell's system, triggering different switches; it may be converted to a digital signal if it meets with a part of the system using digital equipment. LF 22 (Finding of Fact 48) and Exhibit 14 at 14. But the signal must be converted back to analog by the time it reaches its final destination at the end of the phone line -- the human ear cannot hear a digital signal as words and phrases. LF 24 (Finding of Fact 54) and Tr. 647, 650.

In short, Bell's service is not effecting a change in the signal that the customers bargain for, particularly not a lasting change. To the contrary, Bell's customers do not want a change in the signal; they are not paying for anything different to be produced. As the Commission remarked, the value of Bell's phone system to Bell's customers is in the service of transmitting the sound of a human voice from one location to another -- not to make the sound different. LF 42.

The same is true even considering the vertical services separately, though as a preliminary matter, the Director notes that that consideration is not necessary. The legislature appeared to acknowledge the nature of the relationship between an entity such as Bell and Bell's customers when it drafted § 144.020.1(4) to tax the sale of service "to telephone subscribers .... for the transmission of messages and

conversations," and "services pertaining or incidental" thereto. App. A-1. The statutory structure suggests that simply because a telephone company provides services that pertain or are incidental to its provision of "basic" telephone service, that does not transmogrify the company into a manufacturing concern. That appears to be true in the instant case. Were it not for the basic service, which is not manufactured, no evidence suggests that Bell would or even could, whether physically or legally, provide the related services.

But even considering the vertical services separately, the vast majority of them (auto redial, call blocker, call forwarding, selective call forwarding, call return, call trace, call waiting, priority call, speed call, three-way calling, caller ID, anonymous call rejection, and remote access to call forwarding) simply permit customers to choose *when, how*, or *whether* they will have their conversations. For example, caller ID is a service that allows a customer to receive information that can, under certain circumstances, reveal the identity of a caller. The information that accompanies such a call is information that accompanies every call.

That is not manufacturing. In providing such services, Bell does not create anything new; it does not "take something practically unsuitable for any common use and change it so as to adopt it to such common use," *West Lake*, 451 S.W.2d at 143, nor does it produce "new and different articles from raw materials by the use of

machinery, labor and skill, ... in forms suitable for new uses," *Heidelberg*, 531 S.W.2d at 754. Bell is simply repackaging the information that has already entered its system, attendant to its provision of basic service.

Nor do the other services, involving billing (bill plus, customer billing report, and CABS bills on floppy disk) take something practically unsuitable for any common use and change it so as to adopt it to such common use. Bell is simply repacking the information that it already collects, in order to provide additional billing detail to customers who are willing to pay extra. Repackaging billing information, that it already collects, is not manufacturing under this Court's definitions, either. If such repackaging is manufacturing, then the charges that banks impose for providing customers copies of their cancelled checks is arguably manufacturing, too. Applying Bell's arguments, including the argument that "even one" manufactured product transmogrifies any entity into a manufacturing concern, Appellant's Brief, p. 51 n.7, banks could now buy all of their machinery and equipment subject to a manufacturing exemption. That is an absurd result.

Bell's provision of vertical services is somewhat analogous to the facts in *House of Lloyd v. Director of Revenue*, 824 S.W.2d 914 (Mo. banc 1992). The taxpayer in that case received products in shipping cartons. Upon receipt, the taxpayer removed the products from the cartons and then inspected, repaired, sorted, and repackaged the

items for shipping to the taxpayer's customers. The Court held that the product was complete when delivered to the taxpayer, and that the processing did not constitute manufacturing or fabricating. *Id*. at 919. Likewise, when Bell repackages the information that it already gathers when its customers initiate phone calls is not manufacturing, either.

In view of the foregoing, the Commission reached the correct conclusion with regard to manufacturing. Bell is not a manufacturing concern and is not engaged in manufacturing.

The standard of review weighs against Bell. Though the Court's prior decisions including *GTE*, and the plain language of the exemptions, do not support Bell and in fact firmly support the Commission's determination, the Director points out that if the Court believes the decision to be close, or in other words, if "lingering doubt exists as to what was intended," then these statutes "are to be construed against the taxpayer." *Lincoln, supra, citing David Ranken, Jr. Technical Inst. v. Boykins,* 816 S.W.2d 189, 191 (Mo. banc 1991). Contrary to Bell's implication at page 52 of its opening brief, and even though the Commission and the Court obviously must endeavor to interpret the laws in light of the facts that come before them -- whether on a record concerning shoe cobbling, or on a record concerning an enormous computer network -- the Court may not construe the exemptions contained in RSMo. Supp. 1992

to update them, or to adapt them to processes that "were not known or hardly known" at the time they were enacted. *IBM*, 958 S.W.2d at 559, citing *Bridge Data*, 794 S.W.2d at 206. Accordingly, the principle that the exemptions are to be construed against Bell also indicates that the Commission reached the correct result.

III. Bell did not establish that the items were "used directly," within the meaning of the second prong of the exemptions.

Bell suggests that even if its basic telephone service is not manufactured, its vertical services are -- and that all of the purchases can thereby qualify as manufacturing, regardless of the magnitude or lack thereof in overlap of function for basic telephone service. *See* Appellant's Brief, p. 50, n.7 ("Because all of the Machinery & Equipment is used to produce all of [Bell's] vertical services as well as basic telephone service, if [Bell] uses the Machinery & Equipment to manufacture *even one* such service, all of the Machinery & Equipment is exempt under the Manufacturing Exemptions.") (emphasis added). Bell makes this argument, in part, by heavily emphasizing the integrated plant doctrine. Appellant's Brief, p. 48-49. The argument, particularly in light of admissions by Bell's expert, William Deere, says too much.

The Commission made the finding of fact that various components of the telephone system cannot be isolated as providing one service or another. LF 42 (citing Finding of Fact 75). For example, the SS7 system was required to provide some of

the vertical services, but it was also used in providing basic service. LF 42 (citing Findings of Fact 72, 73). Processing of information is required not just with respect to vertical services; it is required even for basic service in order to prepare telephone bills. LF 42 (citing Finding of Fact 76).

The Commission drew its conclusions from at least some of Mr. Deere's testimony. Mr. Deere admitted, upon Commissioner Reine's questioning, that he could not isolate any piece of equipment as a piece of equipment that provides a specific vertical service. Tr. 507-508. But the issue went deeper than mere inability to isolate the equipment. The Commissioner followed up:

> COMMISSIONER REINE: There's not any additional telephone equipment being used because of some of these services than would be used anyway to operate the system for basic telephone service?
>
> MR. DEERE: For most of them, you're correct. But they are there. I mean, there is equipment that is used for that purpose. There is equipment that is being bought to provide that service.
>
> COMMISSIONER REINE: My question is would it have already been there?

MR. DEERE: No, sir.

COMMISSIONER REINE: All right. There's the point I'm trying to make. ...the difference between the equipment provided that's needed and additional equipment that's needed for vertical service than the equipment used for basic telephone service.

MR. DEERE: That's my point is that if the way the telephone system has developed, you cannot totally separate those two. ... [I]f you want to be able to place direct dial long distance calls, if you want to be able to call in town and hear each other better, if you want to be able to have additional value added features, you have to have the new electromagnetic switches. So the whole electronic switch, the whole improvement in the loop facilities, the digital loop electronics, the fiber optics, all of that comes together. None of it is bought to do just one of them. It's bought to do all of them.

Tr. 508 -509.

Thus, Mr. Deere's testimony, set forth above, was that most of the equipment would be in place regardless of the vertical services. Though he testified that the machinery and equipment worked together, he made plain that it was in place to enable customers to do different things -- to place direct dial long distance calls, "to call in town and hear each other better," and to offer "additional value added features[.]" The items were "bought to do all of" those things. But enabling customers to place direct dial long distance calls is not a vertical service,[6] and Bell did not present any evidence that that was manufacturing. Making sure that customers can clearly hear voices when they make local calls is not manufacturing, for the reasons discussed in the preceding section.

Application of the integrated plant doctrine does not resolve the "used directly" issue in Bell's favor, even if the Court decides that Bell is manufacturing (which it should not, in view of the preceding section). First, the Court has never held that items used to *deliver* manufactured products qualifies as machinery or equipment used to manufacture those products. *See Floyd Charcoal Co. v. Director of Revenue*, 599 S.W.2d 173, 178 (Mo. banc 1980). Here, the evidence suggests that at least some of

---

[6] Bell was not, in the 2nd quarter of 1992, or by the time of the hearing before the Commisison, authorized by the Public Service Commission to provide long distance services.

the items at issue deliver the vertical services to customers For example, Bell put on evidence concerning SS7. That is a signaling system that transfers information, but not voices, between switches. LF 24 (Finding of Fact 57). SS7 is used to produce some of the vertical services: caller ID, anonymous call rejection, call redial, call blocker, call return, call trace, select call forwarding, and priority call. LF 27 (Finding of Fact 72).

Third, the Court has never held that the production of "even one" manufactured product, even if the process is integrated, means that an entire operation is a manufacturing concern. Most recently, in reaching the conclusion that a process was sufficiently integrated, the Court in *DST Systems, Inc. v. Director of Revenue*, 43 S.W.3d 799, 803 (Mo. banc 2001), held that though the items at issue "are not used exclusively for the manufacture of the products in question, they are substantially so used." The Commission here, after hearing three days of testimony and reviewing the voluminous exhibits, certainly did not draw the conclusion that Bell proved the items at issue were substantially so used. Rather, the Commission drew the conclusion that the vertical services were incidental to teh provision of basic services. LF 42.

That is a well-founded conclusion, particularly in view of Mr. Deere's testimony and the Commission's findings of fact. Not only are the exemptions to be strictly construed against Bell, Bell bore a heavy evidentiary burden to establish its entitlement to them -- a burden to produce clear and unequivocal evidence. *Concord Publishing*

House v. Director of Revenue, 916 S.W.2d 186, 195 (Mo. banc 1996) (citation omitted). And at the appellate stage, review of the Commission's decision is limited to the determination of whether that decision was supported by competent and substantial evidence on the whole record, or whether it was arbitrary, capricious, unreasonable, unlawful, or in excess of its jurisdiction. *J.B. Vending Co., Inc. v. Director of Revenue*, 54 S.W.3d 183 (Mo. banc 2001) (internal quotations marks and citation omitted). The Commission heard three days of testimony and digested a lengthy documentary record. Its decision was supported by competent and substantial evidence on the whole record, including the admissions of Bell's expert. Nothing about the decision was arbitrary, capricious, unreasonable, unlawful or in excess of its jurisdiction.

Accordingly, if the Court agrees with the Director that basic telephone service is not manufactured, but is inclined to consider the vertical services separately, Bell still cannot prevail. Bell did not and cannot establish that the items that it purchased were substantially used in the manufacture of vertical services.

IV. Bell did not establish that all of the items were machinery and equipment, or materials and supplies solely required for the installation or construction of such machinery and equipment.

The Court has defined machinery as "machines as a functioning unit, ... the constituent parts of a machine or instrument[.]" *Lincoln Industrial, Inc. v. Director of Revenue*, 51 S.W.3d 462, 465 (Mo. banc 2001). Equipment is "all fixed assets other than land and buildings of a business enterprise.... Under this definition, equipment must have a degree of permanence to the business.... In order to qualify for the §144.030.2(4) exemption, equipment must contribute to multiple processing cycles over time." *Walsworth Publishing Co. v. Director of Revenue*, 935 S.W.2d 39, 40 (Mo. banc 1996). The exemption also applies to materials and supplies "solely" required for the installation or construction thereof.

Though the Commission found that almost all of the items at issue were charged to a capital account and depreciated rather than expensed, the Commission held that Bell did not establish how certain items -- notably, many listed in Finding of Fact 105 -- could be regarded as machinery and equipment, or materials and supplies solely used to install such machinery and equipment. LF 47. These items included labels, "labor to install datakit," "installation charges," computer software, and toilet tissue. *Id.* The plain language of the exemptions, and the definitions of machinery and equipment established in cases such as *Walsworth* and *Lincoln*, do not encompass such items.

Further, Bell does not dispute the Commission's footnote 10 of its decision, LF 46, where it noted that while most of the items were charged to a capital account,

several hundred dollars were devoted to "X", or retirement or removal accounts. The Commission held that Bell did not show any basis for including X accounts in the claim. Accordingly, the Commission concluded that even if it were to grant the refund claim, the amount would have to be reduced accordingly. *Id.*

Finally, at least some of the equipment was for pay telephone set-ups, including shelving and signs. TR 599-605. Bell adduced no evidence to demonstrate that pay telephones bore any relation to its provision of vertical services.

V. Bell did not demonstrate that the items were used in or even near the 2nd quarter of 1992.

The Commission noted that one of the problems with Bell's claim was that certain vertical services -- CABS, caller ID, anonymous call rejection, and remote access to call forwarding -- were not offered for sale until after the 2nd quarter of 1992. In the case of anonymous call rejection, it was a seven-year gap. Exhibit 31. The Commission held that were it not rejecting the claims of exemption because of the manufacturing issue, then the claims could be rejected at least with respect to these particular services because they were not available during the period at issue.

Bell takes exception, arguing that *Concord Publishing House, Inc. v. Director of Revenue,* 916 S.W.2d 186 (Mo. banc 1996), compels the contrary conclusion. *Concord* is distinguishable. That case involved, in part, a claim of exemption for

equipment purchased in 1992, and subsequently used, as claimed by the taxpayer, in a pagination system that was implemented in 1993. *Id.* at 189. While the Court held, as Bell points out, that the exemption on statute did not specify when the equipment must be used, the court did not end its discussion there. *Id*. at 194. The Court went on to say that statutes must be interpreted in commonsense fashion, and that common sense dictated allowing the exemption there--the taxpayer's business was small and it was too much of a burden to impose a same-year requirement on its tax-exemept purchases. *Id.*

In contrast to taxpayer in *Concord,* Bell is anything but "small business." It is entirely reasonable to expect it to purchase and use promptly those items for which it would claim a manufacturing exemption. It is particularly reasonable to expect that it would do so more promptly than seven years after the purchase.

Whether the Commission previously permitted a taxpayer to have an exemption for an item used after the purchase period, as Bell argues, Appellant's Brief, p. 52 (*citing Hogan Transports, Inc. v. Director of Revenue*, No. 98-1305RV (Mo. AHC 1999)), is irrelevant. *Hogan* involved another small business, like *Concord*, and a delay of a year or two, again like *Concord*.

VI. If the Court disagrees with the Commission, and finds that Bell is entitled to the exemptions, the decision will have been unexpected and the Court should apply it prospectively.

A court or Commission decision is "unexpected" when "a reasonable person would not have expected the decision or order based on prior law, previous policy or regulation of the" Department of Revenue. §143.903.2, RSMo 2000. If a decision is unexpected, then

> Any provision of law to the contrary notwithstanding, ...[such decision] ...shall only apply after the most recently ended tax period of the particular class of persons subject to such tax imposed by chapter 143 and 144, RSMo, and any credit, refund or additional assessment shall be only for periods after the most recently amended tax period of such persons.

§143.903.1, RSMo 2000.

If this Court were to determine that Bell is engaged in manufacturing, the decision would be unexpected, in view of the development of the caselaw concerning the manufacturing exemptions, discussed in the foregoing sections. It would be particularly unexpected in view of the discussions in *GTE* and *Bridge Data* that the

provision of telephone services is not manufacturing, and the legislature's apparent agreement with those discussions in its subsequent amendments of the taxability statutes that did not undo those aspects of the decisions. Further, the Commission discussed the caselaw at some length, including *GTE* which, while recognizing that the decision had been trimmed somewhat in *IBM*, the Commission found "useful in determining whether Bell performed a manufacturing service." LF 38 n.7.

Accordingly, if the Court does agree with Bell herein, such a decision should be applied prospectively only.

_____.

Conclusion

In view of the foregoing, the Court should affirm the decision of the Administrative Hearing Commission.

Respectfully submitted,

JEREMIAH W. (JAY) NIXON
Attorney General

ALANA M. BARRAGÁN-SCOTT
Missouri Bar No. 38104
Deputy State Solicitor

P.O. Box 899
Jefferson City, Missouri 65102
(573) 751-3321
(573)751-9456 (facsimile)

ATTORNEYS FOR RESPONDENT
DIRECTOR OF REVENUE

Certification of Service and of Compliance with Rule 84.06(b) and (c)

The undersigned hereby certifies that on this 7th day of December, 2001, one true and correct copy of the foregoing brief, and one disk containing the foregoing brief, were mailed, postage prepaid, to:

Juan D. Keller
B. Derek Rose
Bryan Cave LLP
One Metropolitan Square
211 North Broadway, Suite 3600
St. Louis, Missouri 63102-2750

Edward F. Downey
Bryan Cave LLP
221 Bolivar Street, Suite 101
Jefferson City, Missouri 65101

The undersigned further certifies that the foregoing brief complies with the limitations contained in Rule No. 84.06(b), and that the brief contains 8,011 words.

The undersigned further certifies that the labeled disk, simultaneously filed with the hard copies of the brief, has been scanned for viruses and is virus-free.

_____
ALANA M. BARRAGÁN-SCOTT

Appendix

Section 144.020. Rate of tax -- tickets, notice of sales tax. -- 1. A tax is hereby levied and imposed upon all sellers for the privilege of engaging in the business of selling tangible personal property or rendering taxable service at retail in this state. The rate of tax shall be as follows:

*****

(4) A tax equivalent to four percent on the basic rate paid or charged on all sales of service to telephone subscribers and to others through equipment of telephone subscribers for the transmission of messages and conversations, both local and long distance, and upon the sale, rental or leasing of all equipment or services pertaining or incidental thereto[.]

*****

Section 144.010. Definitions. -- 1. The following words, terms, and phrases when used in sections 144.010 to 144.525 have the meaning ascribed to them in this section, except when the context indicates a different meaning:

*****

(8) .... Where necessary to conform to the context of sections 144.010 to 144.510 and the tax imposed thereby, the term "sale at retail" shall be construed to embrace:

*****

> (c) Sales of service to telephone subscribers and to others through equipment of telephone subscribers for the transmission of messages and conversations, both local or long distance, and the sale, rental or leasing of all equipment or services pertaining or incidental thereto[.]

*****